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The banking union

The Commission believes there has to be a clear longer term perspective on the future of the EU's Economic and Monetary Union to give a sense of direction to the reforms and decisions necessary for the EU and its Member States to tackle their current challenges.

Therefore, the Commission has been pushing for deeper economic integration as one of the remedies to the current crisis. This new step in European integration would complement our monetary union. In this context, the Commission is putting forward the concept of a banking union as one of the "building blocks", which should pave the way towards this integration.

The concept of a banking union was put forward by President Barroso at the last informal European Council, which took place on 23 May. It will be discussed in the coming weeks by EU leaders.

The European banking union is not a new legal instrument to be drafted. It is a political vision for more EU integration, which will build on recent major steps to strengthen the regulation of the banking sector.

The President of the European Council will present a report in close collaboration with the President of the European Commission, the Chair of the Eurogroup and the President of the European Central Bank to the next European Council (28-29 June). In the context of the preparation of this report, the main building blocks towards a deeper economic and monetary integration including the banking union will be extensively discussed as well as the working methods.

Once this vision is agreed at political level, the Commission will propose the necessary measures to implement this new policy objective.

Many things have been done over the past three years to strengthen our banking sector. Some key proposals are still pending before Parliament and Council, and should be adopted soon. Further proposals might be needed to complement these and to make a qualitative step towards a true banking union.

1. EU banking regulation: what have we done?

Since the beginning of the crisis, the European Commission has tabled around 30 proposals to improve regulation of the financial system and benefit the real economy. This represents a solid basis for a future banking union. The Commission has also contributed to strengthening financial stability and the banking sector through its state aid control policy and the different stability and adjustment programmes.

The Commission took the following actions:

1.1 Measures to allow for more integrated banking supervision:

- **Three European supervisory authorities** were established on 1 January 2011 to introduce a supervisory architecture:
- the **European Banking Authority** (EBA), which deals with bank supervision, including the supervision of the recapitalisation of banks,
- the **European Securities and Markets Authority** (ESMA), which deals with the supervision of capital markets
- and the **European Insurance and Occupational Pensions Authority** (EIOPA), which deals with insurance supervision.

The 27 national supervisors are represented in all three supervising authorities. Their role is to contribute to the development of a single rulebook for financial regulation in Europe, solve cross-border problems, prevent the build-up of risks, and help restore confidence. They can, for example, ban products that threaten the stability of the overall financial system in emergency situations. Individual ESAs have specific roles: for example ESMA is the EU supervisor of credit rating agencies, while EBA and EIOPA carry out "stress tests" of their respective sectors and EBA has overseen the current recapitalisation exercise of EU Banks.

In addition, the European Systemic Risk Board (ESRB) has been tasked with the macro-prudential oversight of the financial system within the Union.

This new financial supervision framework has been in place since November 2010.

For more information on financial supervision, see MEMO/10/434.

1.2 Strengthening the banking system,

By securing better capitalisation:

Banking institutions entered the crisis with capital that was insufficient both in quantity and in quality, leading to unprecedented support from national authorities. With its proposal on bank capitalisation ("CRD IV") made in July last year, the Commission launched the process of implementing for the European Union the new global standards on bank capital agreed at the G20 level (most commonly known as the Basel III agreement). Europe is playing a leading role on this matter, applying these rules to more than 8,000 banks, representing 53% of global assets.

The Commission also wants to set up a new governance framework giving national supervisors new powers to monitor banks more closely and take action through possible sanctions when they spot risks, for example to reduce credit when it looks like it is growing into a bubble. European supervisors would intervene for example in cases of disagreement between national supervisors in cross-border situations.

For more information on EU measures on bank capitalisation, see IP/11/915.

By facilitating banking sector restructuration:

Extensive financial sector conditionality has been included among the policy requirements addressed to Member States that have received international financial assistance.

With respect to the banking sector, the required policy measures consist, on the one hand, of the orderly winding-down of non-viable institutions and, on the other hand, of the restructuring of the viable banks. Higher capital requirements, recapitalisations of banks, thorough stress tests, deleveraging targets as well as enhancing the regulatory and supervisory frameworks have also been part of the policy initiatives. While not specific to programme countries, these stabilisation measures are most easily implemented in the context of international financial assistance.

Further, it is recalled that the European Financial Stability Facility (EFSF) can provide loans to a non-programme euro area Member States for the specific purpose of recapitalising financial institutions, with the appropriate conditionality, institution-specific as well as horizontal including structural reform of the domestic financial sector.

Specific bank restructuring under the programme goes hand in hand with the conditionality of EU state aid rules.

Concrete examples of measures targeting the banking sector taken in the framework of the macro-economic adjustment programmes or balance of payments assistance programmes

In Greece, €50 billion have been allocated to the Hellenic Stability Financial Fund for the purpose of bank recapitalisation. In Portugal, the €12 billion of the Bank Solvency Support Facility have been earmarked on a dedicated account at the central bank.

With respect to the non-euro area countries which have received balance-of-payments assistance, the Latvian programme also included a banking support envelope of €600 million. While these financial resources are an integral part of the international financial assistance packages, the latter's key contribution to the stabilisation of the financial sectors derives from the programme-driven restructuring of banks.

For more information on the programmes please see:

http://ec.europa.eu/economy_finance/eu_borrower/greek_loan_facility/index_en.htm

http://ec.europa.eu/economy_finance/eu_borrower/portugal/index_en.htm

http://ec.europa.eu/economy_finance/eu_borrower/balance_of_payments/latvia/latvia_en.htm

By offering more protection to bank deposits:

Thanks to EU legislation, bank deposits in any Member State are already guaranteed up to €100,000 per bank account if a bank fails. From a financial stability perspective, this guarantee prevents depositors from making panic withdrawals from their bank, thereby preventing severe economic consequences.

In July 2010, the Commission proposed to go further, with a harmonisation and simplification of protected deposits, faster pay-outs and improved financing of schemes, notably through ex-ante funding of deposit guarantee schemes and a mandatory mutual borrowing facility. The idea behind this is that if a national deposit guarantee scheme finds itself depleted, it can borrow from another national fund. This would be the first step towards a pan-EU deposit guarantee scheme. This proposal is still being discussed by the Council and Parliament in second reading.

For more information on the Commission's proposal for a European system of deposit guarantees, see IP/10/918.

By calibrating its state aid control:

How has the Commission controlled state aid to banks during the crisis?

When financial markets were on the brink of collapse, the natural instinct of some policy-makers was to put our common rules aside and act unilaterally. Without some form of EU-wide coordination, we could have seen a subsidy race, massive transfers of capital from one country to another, and probably the end of the internal market as we know it.

We were quick to put into effect a crisis regime. In autumn 2008, the Commission swiftly published guidance explaining how Member States could assist distressed banks or businesses in line with EU state-aid rules. This guidance was based on Article 107(3)(b) of the Treaty on the Functioning of the EU (TFEU), which allows state aid to remedy a serious disturbance in the economy of a Member State.

A first Communication, adopted in October 2008, spelt out basic principles for support schemes, such as keeping support limited in time and scope, ensuring that eligibility for a support scheme was not based on nationality or avoiding that beneficiary banks unfairly attract new additional business solely as a result of the government support (see IP/08/1495). A good illustration is the Irish support scheme for banks, which was amended so as to ensure a non-discriminatory coverage of banks with systemic relevance to the Irish economy, regardless of origin (see IP/08/1497).

This was followed by a Communication on the recapitalisation of banks in December 2008, tackling the need to recapitalise banks, address solvency issues and access to credit for the real economy (see IP/08/1901) and in February 2009 by the "Impaired Assets Communication" providing a framework to deal with the problems of toxic assets (see IP/09/322).

Finally, in July 2009, the Commission adopted the "Restructuring Communication", providing clarity on how the Commission would examine the restructuring of banks so that they can return to long-term viability, share the weight of the cost of their rescue, and address any distortions of competition resulting from the large amounts of aid the banks received (see IP/09/1180). Since 1 January 2011, every bank requiring state support in the form of capital or impaired asset measures has had to submit a restructuring plan (and not only distressed banks, as in the past).

Cases illustrating how the restructuring of important banks was guided by these rules include KBC (see IP/09/1730) and Lloyds (see IP/09/1728).

What has been the Commission's practice so far?

When controlling state aid to banks, the Commission has been acting as a de facto crisis-management and resolution authority at EU level, working to address the structural problems that had been affecting many banks since well before the crisis. Three main goals guide our work: safeguarding financial stability, preserving the integrity of the internal market, and ensuring that the beneficiaries of aid return to long-term viability. The restructuring which we asked is based on three principles: that the bank returns to long term viability without the need for further State support, that the bank and its shareholders and hybrid capital holders contribute to the costs of its restructuring, and that the competition distortions caused by the aid are mitigated. For instance, we have asked some banks to move away from unsustainable business models based on excessive leverage and the over-reliance on short-term wholesale funding. In other cases, we have required a downsizing and the simplification of banking structures. Finally, when it was clear that the viability of a bank could not be restored, its orderly resolution was put in place. In all cases, we ask banks to pay back the aid received from their governments. This condition is vital, because it addresses the moral-hazard issue and limits the cost to the taxpayer.

To give a few examples: this has resulted in the deep restructuring and the partial resolution of banks such as Hypo Real Estate (see IP/11/898), Kommunalkredit (see IP/11/389), and Northern Rock (see IP/09/1600). The unsustainable business model adopted by some German Landesbanken has resulted – in cases such as LBBW (see IP/09/1927) and HSH (see IP/11/1047) – in the re-focussing on their core business. In the case of WestLB – the viability of which could not be restored – the result was an orderly resolution (see IP/11/1576). In other occasions, governments have had to take over the burden of wrong business decisions adopted by systemically important banks. In these cases, we have requested a downsizing and the significant simplification of banking structures, such as with ING and Commerzbank (see IP/09/711).

How long will the crisis regime for state aid to the financial sector apply? What will happen afterwards?

State aid control in the crisis always had two goals: on the one hand, we had to put out the fire; on the other, we prepared the ground for the post-crisis scenario. Since the beginning, we have imposed restructuring conditions that were designed to bring more stability to the financial markets and to help banks return to financing the real economy. These conditions include that banks remunerate and eventually repay the public support and that shareholders and hybrid-capital holders bear a fair share of the burden to address the moral hazard issue.

We were getting ready to move from the emergency regime to more permanent, post-crisis rules at the end of 2011. But the renewed tensions in the markets led us to extend the crisis regime into 2012, prolonging all four banking Communications, with some modifications. This was mainly to ensure that the state is adequately remunerated when, as is increasingly likely in the future, Member States decide to recapitalise their banks using instruments such as ordinary shares, for which the remuneration is not fixed in advance. A revised methodology was also agreed concerning the remuneration of guarantees for banks' funding needs – the bulk of the support to date – to ensure that the fees banks pay reflect their intrinsic risk, rather than the risk related to the Member State concerned or the market as a whole (see IP/11/1488).

The rules will apply as long as required by market conditions. As soon as market circumstances allow, the Commission will adopt a permanent regime for state aid to the financial sector.

1.3 Other measures to strengthen Europe's financial sector

In addition to reinforcing the supervision of the financial sector, increasing protection for bank depositors, strengthening capital requirements for financial firms, and improving crisis management in the banking sector, the Commission is also working:

- to examine reform of the structure of the banking sector though the work of the high-level expert group headed by Erkki Liikanen (see MEMO/12/129);
- to regulate shadow banking (see IP/12/253)
- to make credit ratings more reliable (see IP/11/1355);
- to tighten rules on hedge funds (see IP/09/669), short selling (see IP/10/1126) and derivatives (see IP/10/1125);
- to revise current rules on trade in financial instruments (see IP/11/1219), market abuse (see IP/11/1217) and investment funds (see IP/10/869);
- to curb banking pay practices that encourage recklessness (see IP/09/1120);
- to reform the sectors of audit (see IP/11/1480) and accounting (see IP/11/1238).

2. Further measures already on the agenda

Proposal on resolution tools for banks in crisis

The Commission's proposal on resolution tools for banks in crisis, due to be adopted today, is the last in a series of proposed measures to strengthen Europe's banking sector and avoid the spill-over effects of any future financial crisis, with negative effects on depositors and taxpayers.

To ensure that the private sector pays its fair share in any future bailouts, the EU will propose a common framework of rules and powers to help EU countries intervene to manage banks in difficulty. Repeated bailouts of banks have fuelled a public perception of deep unfairness, increased public debt and imposed a heavier burden on taxpayers.

A common EU-wide framework of tools for bank recovery and resolution would offer tools to prevent crises from emerging in the first place and address them early on if they do.

This will provide a set of tools allowing for the managed resolution of systemically important institutions where necessary.

What instruments will the European Stability Mechanism (ESM) offer for the banking sector?

The European Stability Mechanism (ESM) will have a lending capacity of €500 billion. For euro area Member-States not subject to a programme, the ESM will have the possibility of providing a loan for the specific purpose of re-capitalising financial institutions. The granting of such financial assistance is subject to a positive decision of the Board of Governors of the ESM, i.e. the finance ministers of the euro area Member States. The conditionality attached to financial assistance shall be detailed in a Memorandum of Understanding and will include institution-specific as well as horizontal conditionality. Recapitalisations can also be conducted under a loan accompanied by a fully fledged macroeconomic adjustment programme. The ESM Treaty does not currently foresee direct lending by the ESM to a financial institution.

3. Other ideas feeding reflections for the future

The following proposals should be considered when mapping out the next steps towards a banking union:

- **an integrated system for the supervision of cross-border banks**

While the current role of the European supervisory authorities is mainly to oversee the functioning and convergence of national supervisory systems, the Commission is intended to assess how this system is working in order to consider whether it would be appropriate for them to directly supervise financial institutions with a pan-European reach.

- **a single deposit guarantee scheme:**

In the context of the DGS reform in 2010 Commission suggested that it would submit a report on the need for existing deposit guarantee schemes to be replaced by a single scheme for the whole Union.

- **an EU resolution fund**

Our today's proposal on resolution tools for banks in crisis may be considered as a first step in this direction.

Member States are offered the option, instead of creating separate resolution funds, to merge the DGS and the resolution financing arrangement. See MEMO/12/416.

Further, the Commission proposes the setting up of funds at national level which would interact and lend to one another when necessary, notably in the case of cross-border groups, to constitute a European system of resolution funds. Furthermore, the closer integration of supervisory and resolution arrangements for cross-border institutions will be explored further in the context of this mapping out exercise.

As to the prospects of allowing the EFSF and/or the ESM to offer aid directly to banks, this is also an important issue, not in the short-term, but rather in the medium to long-term, Possibility of avoiding or breaking the link between the sovereigns and the banks may be considered as an alternative for direct bank recapitalisation, which is not part of the ESM Treaty for the moment in its present form. It should nourish reflections in the future in order to go to the roots of this current debt crisis.